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# In the Supreme Court of the United States

OCTOBER TERM, 1970

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No. 235

STANLEY, INC., PETITIONER

*v.*

PAUL A. SCHUSTER, DISTRICT DIRECTOR, INTERNAL REVENUE SERVICE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT*

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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### OPINIONS BELOW

The memorandum of decision and judgment of the district court (Pet. App. 17-31) is reported at 295 F. Supp. 812. The *per curiam* order of the court of appeals (Pet. App. 16) is reported at 421 F. 2d 1360.

### JURISDICTION

The judgment of the court of appeals was entered on March 9, 1970 (Pet. App. 16), and a petition for

rehearing *en banc* was denied on March 31, 1970 (Pet. 2). The petition for a writ of certiorari was filed on June 8, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## QUESTION PRESENTED

Whether, in the circumstances, both courts below correctly held that a transfer of property constituted a transfer to a controlled corporation under Section 351 of the Internal Revenue Code, with the transferee taking a carryover basis in the property, rather than a sale of the property resulting in an increased basis.

## STATUTES INVOLVED

The pertinent statutory provisions applicable to the taxable year here in issue are set forth in Appendix A, *infra*, pp. 11-12. Section 385 of the Internal Revenue Code, which was added by the Tax Reform Act of 1969, is set forth in Appendix B, *infra*, p. 13.

## STATEMENT

In 1947, Dr. Robert E. S. Young formed a corporation, Turkey Run, Inc., to which he transferred certain real estate in exchange for 245 of the 250 shares of stock issued by the corporation (R-T. 15a).[1] Thereafter, Dr. Young periodically made gifts of this

[1] "R." references are to the two-volume appendix filed in the court of appeals and certified to this Court. "R-T." refers to the record appendix, and "R-E." refers to the exhibits volume.

stock to his three children until 1963 when he transferred his last share to them (R-T. 15a; R-E. 5a).

Petitioner, Stanley, Inc., was also incorporated by Dr. Young, who received all 45 shares of its stock in 1958 and 1959 for a total consideration of $4,500 (R-T. 14a, 25a, 27a). At all times, Dr. Young was the sole shareholder of petitioner and served as its president and treasurer (R-T. 14a, 18a, 25a).

On November 10, 1962, Turkey Run transferred a tract of the above-mentioned land to petitioner, which executed a promissory note for $247,000 in exchange. The "Purchase and Sales Agreement" provided that the note would be paid in four annual installments. (R-T. 25a; R-E. 6a-8a.) Immediately thereafter, petitioner contracted to have the property subdivided, developed and sold, and all but ten lots were sold in 1963 (R-T. 17a; R-E. 26a-35a).

The ultimate issue in this case concerns the amount of gain realized by petitioner in 1963 from the sale of these lots. Petitioner contends that the transfer of property from Turkey Run to it constituted a bona fide sale, so that its basis in the property was $247,000. The government's position is that the transfer was a transfer to a controlled corporation (a corporation in which the transferors own at least 80 percent of the transferee's stock) pursuant to Sections 351 and 368 of the Internal Revenue Code, which results in a carryover basis to the transferee under Section 362. Alternatively, if the transaction does not qualify under Section 351, the basis nevertheless should be carried over, because Turkey Run's transfer constituted a contribution to petitioner's capital within the meaning of Section 362.

From its incorporation, petitioner had only $99.84 in available cash, compared to a liability of $247,000 following the transfer of land from Turkey Run for petitioner's note. The "note" required no interest unless payments of principal were in default, and the accompanying mortgage was released prior to the required payments on the note. The land was petitioner's only asset, and it had to borrow additional funds from Turkey Run to meet initial development costs. Repayment of the note was therefore inextricably tied up with the success of the venture, and, as a practical matter, Turkey Run bore the entire risk of the venture. Other evidence indicated that Turkey Run pledged its own assets as security to contractors negotiating with petitioner, and that Turkey Run subordinated its interests to that of another creditor. (R-E. 14a; R-T. 27a.)

The district court held on these facts that the transfer of land from Turkey Run to petitioner was not a bona fide sale creating a debtor-creditor relationship, but was in the nature of an equity contribution (R-T. 26a, 28a). It also determined that Dr. Young's transfer of cash to petitioner in exchange for stock, and Turkey Run's transfer of property to petitioner in exchange for an equity interest in the form of a promissory note, were so completely interdependent and necessary to the financing of petitioner that they must be considered together. So considered, they constituted a transfer to a controlled corporation within the meaning of Sections 351 and 368, because, immediately after the transfer, Dr. Young and Turkey Run owned all of petitioner's stock. Accordingly, the

district court concluded that, notwithstanding the form of the transaction, Turkey Run's transfer resulted in a carryover basis for the land in the hands of petitioner. (R-T. 30a-31a.) On appeal, the Sixth Circuit affirmed for the reasons set forth in the opinion of the district court (Pet. App. 16).

## ARGUMENT

The decision below is correct. There is no conflict or any other reason for further review by this Court.

1. The "basis" question in this case arose out of the transfer of property from one corporation to another, both owned and controlled by the same close family unit, with Dr. Young, the president and treasurer of both corporations, acting as negotiator for both. The record supports the district court's determination that this transaction was not a bona fide sale, but an equity investment by Turkey Run in petitioner. Among other things, the court considered petitioner's almost complete lack of capital and the fact that Turkey Run bore the entire risk of the venture. It supplied the additional funds required for development costs; it pledged its own assets as security to facilitate petitioner's negotiations with contractors; and it subordinated its interests to that of another creditor. The fact that the four-year "note" for $247,000 required no interest unless payments were in default, and that the accompanying mortgage was released prior to payments on the note are further evidence that this transfer was not an "arm's-length" transaction. These are all relevant considerations in determining whether a transaction

constitutes a bona fide sale and indebtedness or a capital investment. *Nassau Lens Co.* v. *Commissioner*, 308 F. 2d 39 (C.A. 2); *Burr Oaks Corp.* v. *Commissioner*, 365 F. 2d 24 (C.A. 7); *Camp Wolters Enterprises* v. *Commissioner*, 230 F. 2d 555 (C.A. 5); *Aqualane Shores, Inc.* v. *Commissioner*, 269 F. 2d 116 (C.A. 5).

Section 362, Appendix A, *infra*, p. 11, provides that if property is acquired by a corporation in connection with a Section 351 transfer, or as a contribution to capital, the basis of the property is the same as it was in the hands of the transferor. The conclusion of the court below that Turkey Run's interest in petitioner was an equity interest thus is sufficient in itself to support the court's holding that the transfer in question resulted in a carryover basis for the land in the hands of petitioner (Pet. App. 30). See *P. M. Finance Corp.* v. *Commissioner*, 302 F. 2d 786 (C.A. 3); *Foresun* v. *Commissioner*, 348 F. 2d 1006 (C.A. 6). But the court below also was correct in holding that the transfer was one to a controlled corporation under Section 351.

Section 351, Appendix A, *infra*, p. 11, is a "nonrecognition" provision making certain transfers of property to a corporation in exchange for corporate stock or securities nontaxable exchanges. It includes transfers by two or more persons, pursuant to a common scheme, to a corporation that they control collectively within the meaning of Section 368, Appendix A, *infra*, p. 12. *Burr Oaks Corp.* v. *Commissioner*, *supra*; *Camp Wolters Enterprises* v. *Commissioner*, *supra*. Moreover, separate transfers of property to a

corporation do not have to be made simultaneously to qualify for Section 351 treatment where together they constitute "an integral part of the scheme of its forming and financing." *Camp Wolters Enterprises* v. *Commissioner*, *supra*, p. 559. Here, although four years elapsed between the two transfers, petitioner had not been "fully formed and launched" for business purposes and, indeed, "was not financially capable of doing business," until its acquisition of land from Turkey Run (Pet. App. 25). Under these circumstances, the courts below were fully justified in concluding that the transfers were integrally related to petitioner's formation and financing.

Considering the transfers as part of an integrated transaction, they clearly meet the requirements of Section 351. Turkey Run and Dr. Young transferred property—land and cash, respectively—to a corporation solely in exchange for stock or securities, and, immediately thereafter, they were collectively in control of the corporation. As a result of the transfers, they effected only a change in the form of ownership within the family unit. While before the transfers, the three children and Dr. Young held the property as shareholders of Turkey Run (Dr. Young owned one share of Turkey Run at that time), after the transfers, the children's interest was an equity interest in the form of a note and Dr. Young's interest was an equity interest in the form of common stock.

2. *American Bantam Car Co.* v. *Commissioner*, 11 T.C. 397, affirmed *per curiam*, 177 F. 2d 513 (C.A. 3), certiorari denied, 339 U.S. 920, cited by petitioner (Pet. 8), does not call for a result contrary to that

reached below. The issue in that case was whether the taxpayers, after transferring assets to a corporation in exchange for stock, had the immediate "control" required for a nontaxable exchange, when a new issue of stock 15 months after the exchange caused the taxpayers to have less than the required 80 percent control. Considering the intent of the parties, the ultimate result, and the time lapse and interdependence of the steps, it was held that the earlier and later transfers should not be considered a single transaction. Applying the same criteria to the facts of this case (Pet. App. 23-25), the district court held that the steps were, in substance, part of a single transaction. The two cases are distinguishable in a number of respects, but it is sufficient to point out that *American Bantam Car* did not turn on whether the corporation there involved was financially capable of conducting business between the time of the earlier and later transfers.[2]

3. Petitioner has pointed to no conflicting decisions which would warrant review by this Court. *Byerlite Corp.* v. *Commissioner*, 286 F. 2d 285, like the instant case, was decided by the Sixth Circuit. *Byerlite, J. S. Biritz Construction Co.* v. *Commissioner*, 387 F. 2d 451 (C.A. 8), *Rowan* v. *United States*, 219 F. 2d 51 (C.A. 5), and *Miller's Estate* v.

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[2] The district court's conclusion that the transfers were part of a single transaction does not ignore the corporate entity of petitioner during the period between the transfers, as is asserted (Pet. 8). It recognizes that although petitioner was in existence during this period, its financial position precluded meaningful business operations.

*Commissioner*, 239 F. 2d 729 (C.A. 9), all involved the question whether advances to a corporation were true loans or capital investments. The issue in *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118 (C.A. 2), was whether debentures issued in payment of declared dividends constituted valid indebtedness. The underlying factual situations in the cited cases are wholly different from the factual situation presented here. Moreover, contrary to petitioner's apparent contention (Pet. 10-14), none of those cases purports to establish an absolute rule binding the Commissioner to the form chosen by taxpayers for their transactions and forbidding him from examining the substance. Nor do any of them hold that the ratio of debt to equity of a corporation—the thin capitalization factor—is irrelevant to the question whether a particular interest in a coporation is stock or indebtedness.

4. At all events, further review of this question is inappropriate at this time. In the recently enacted Tax Reform Act of 1969, Congress recognized that debt-equity questions arise frequently in the tax law and in a variety of contexts. For this reason, it added Section 385 to the Code (Tax Reform Act of 1969, Section 415(a), P.L. 91-172, 83 Stat. 613), which authorizes the Commissioner to issue regulations providing rules for distinguishing between debt and equity in all situations arising under the tax law. See Appendix B, *infra*, p. 13. It is expected that the new rules will clarify the entire debt-equity area. In this regard, it is to be noted that among the factors to be taken into account by the Commissioner in pro-

mulgating the rules are the ratio of debt to the corporation's equity, whether the debt is subordinated to other indebtedness, and the relationship between stockholdings in the corporation and the holdings of the interest in question. The courts below placed principal reliance on these factors in concluding that Turkey Run's interest in petitioner was an equity interest.

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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JULY 1970.

## APPENDIX A

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) *General Rule.*—No gain or loss shall be recognized if property is transferred to a corporation * * * by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368 (c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

* * * *

SEC. 362. BASIS TO CORPORATIONS.

(a) *Property Acquired by Issuance of Stock or as Paid-In Surplus.*—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

* * * *

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

* * * * *

(c) *Control.*—For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

## APPENDIX B

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 385 [as amended by Sec. 415(a), Tax Reform Act of 1969, P.L. 91-172, 83 Stat. 613]. TREATMENT OF CERTAIN INTERESTS IN CORPORATIONS AS STOCK OR INDEBTEDNESS.

(a) *Authority to Prescribe Regulations.*—The Secretary or his delegate is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness.

(b) *Factors.*—The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,

(2) whether there is subordination to or preference over any indebtedness of the corporation,

(3) the ratio of debt to equity of the corporation,

(4) whether there is convertibility into the stock of the corporation, and

(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

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